F R E E M A R K E T
GOLD & MONEY
R E P O R T
A Commentary on Precious Metals and Monetary Matters by James Turk
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Capital Heads Home

Something unusual happened this past Thursday and Friday that made me stand up and take notice. As the stock market was falling, the Dollar was getting trashed. The Dollar dropped against all the major currencies, and against the best ones, it fell hard. For example, in those two days the Dollar lost 4.5% against the Swiss Franc. By Friday the Dollar was even falling against the lowly Canadian and Australian Dollars, currencies that had been in a free-fall in recent months. We have not seen such severe Dollar weakness for some time. What is going on?

My conclusion is that the tide has finally turned for the Dollar. Capital is heading home, and the implications for the Dollar, the US economy and the stock market are ominous indeed.

Long-time readers of these letters know that the Dollar is in a long-term bear market. It does have bear market rallies from time to time, like the one the Dollar enjoyed over the past few years. But I have pointed out before that all the talk about "Dollar strength" was misguided. The Dollar has not made a new high against the Swiss Franc and Deutschemark since August 1997, so it would be more precise to say in recent months that we have been seeing Yen weakness, not Dollar strength.

Also, the drop in the Yen goes a long way to explaining the drop in the Canadian and Australian Dollars. Both of these countries are heavily dependent upon exports to Japan, so as the Yen fell, these two currencies fell along with it. But now the currency markets appear to have reached a turning point. The Dollar is falling against all currencies and falling fast. And it is significant the stock market is dropping at the same time.

Overseas investors are cashing in, and turning their Dollars back into their home currency. Capital is heading home, perhaps due in part to the Russian crisis. The Russian financial collapse is showing the fragility of the international monetary situation.

For example, the Russians have reminded investors it only takes some politician's edict to close any financial market, freezing their assets perhaps forever. And we have also seen the weakness of the IMF. Their $5 billion loan was used by the Russian government not to repay debts but to defend the Rouble! That $5 billion is gone, the Rouble is gone, but the debts remain.

More ominously for the Russians and other countries that may soon need some IMF largesse is the IMF's own precarious financial position. The IMF is running out of money, a prospect that is further spooking international investors

The disarray in financial markets throughout the world is made even more stark by the absence of US Treasury Secretary Robert Rubin. Where is he? Why has he had nothing to say about the current crises?

You will recall that his strong Dollar policy, which is of course the right policy to pursue, was overruled in June by Clinton for political reasons — the Treasury at the time asked the Federal Reserve to sell Dollars and buy Yen before Clinton's trip to China. Now the Dollar has all the earmarks of beginning to spiral out of control.

Does Mr. Rubin believe he has been undermined, perhaps neutered, because Clinton politicized the Dollar by showing he is willing to manipulate the currency for perceived short-term political gains? Or perhaps, has Mr. Rubin disappeared because he senses that the current crises are terminal, that the regime of worldwide fiat currencies in place since Nixon abandoned the Gold Standard in 1971 is about to end in tears?

What we are seeing I believe is the beginning of a flight from currencies worldwide. The bear markets in Asia have finally brought bear markets to the US and Europe. In a bear market, fear rises. This fear causes investors to seek safety, and they do this by bringing capital back to their home shores. For safety, capital is once again heading home.

Countries like Korea, Indonesia and Russia had been living on borrowed money. Unfortunately for them, they learned that borrowed money is also hot money. And which country is the biggest borrower of hot money? The United States. It is the world's largest debtor, which has caused the global economy to be flooded with Dollars.

When the world believed in Mr. Rubin and his strong Dollar policy, the US scraped by without any adverse effects. But now the tide is turning. Mr. Rubin is nowhere to be seen, his strong Dollar policy in shambles. And so too will the Dollar soon be in shambles, even against what has been a weak Yen.

Speaking to his nation on August 26th, Japan's Vice Minister for International Affairs Eisuke Sakakibara said: "It is important for Japanese investors to lock in profits in any foreign currency transaction." He did not elaborate, but he didn't need to. The message was clear.

If you were short Yen, close out your trade. If you owned foreign assets, like US stocks and T-Bonds, sell them and bring the capital back home. The Japanese government is about to take action to strengthen the Yen.

The Dollar's rise against the Yen has ended. We can therefore conclude that the Dollar has now peaked against all the world's currencies. So the Dollar has only one way to go from here — down. ¤

Q&A I have been inundated with questions from subscribers over the past few weeks. Here is my response to some of them, which in some cases for clarity or brevity have been paraphrased or combined with similar questions.

Why isn't Gold responding to the various currency crises?

Gold is responding, if you measure the Gold price in terms of Indonesian Rupiah, Thai Baht, Russian Rouble, and all the other currencies that have collapsed. Gold did exactly what it was supposed to when these currency crises hit — it protected purchasing power. The Indonesians, Thais and Russians who owned Gold were glad that they did.

So far, however, the US Dollar price of Gold has not responded. There are a couple of reasons for this turn of events.

First, I continue to believe that the Dutch central bank is dishoarding its Gold. When they finally announce their dishoarding, look for the Dollar Gold price to turn higher — if it hadn't already turned higher before the announcement. This weight of Gold, along with the huge positions amassed by the short-sellers has put Gold under pressure. But Gold has also been under pressure for a second reason.

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Currency crises and stock market collapses are a two-step affair. In the first step, there is a rush for liquidity. In a page 1 article on August 28th, *The Wall Street Journal* reported in a timely article that "A Global Margin Call Rocks Markets, Banks". In any rush for liquidity such as the current one, Gold more often than not gets sold along with most everything else that has liquidity. To meet the margin call, investors and hedge funds sell the liquid assets, and are forced to hold on to their real estate, Russian bonds, and other illiquid assets.

Gold shines in the second part of the crisis — when fear starts rising. Fear causes investors to seek certainty, a task at which Gold excels because it is the only money that is no one else's liability. Look for the fear to begin rising.

Recent events in Asia prove this principle. In the first quarter, Gold demand in Asia dropped precipitously. Those who owned Gold sold it after the crisis seeking liquidity. The World Gold Council has reported that the situation turned around in the second quarter. Demand for Gold in Asia is rising rapidly, lock-step with the rising levels of fear as their economies collapse and as their insolvent banks are about to close.

Will the share purchases by the Hong Kong monetary authorities stop the slide in the Hang Seng Index?

Probably not, even though these authorities have a lot of ammunition — Hong Kong has one of the world's largest hoards of foreign currency. All they are doing is monetizing shares. The authorities are putting stocks on their balance sheet and paying for them with newly created Hong Kong Dollars. The results of this policy are threefold.

It makes it easy for anyone with big positions in Hong Kong to exit the market. It helps the big hedge funds establish new short sales, and ultimately it weakens the Hong Kong Dollar.

Buying stocks is a doomed policy that makes no sense — all one has to do is study what John Law tried to do to keep the Mississippi bubble from collapsing in 18th century France. But I am always utterly amazed by the folly of government 'planners' who believe they can out-think the market. As Ludwig von Mises so cogently warned, governments will destroy markets long before they ever understand how they work.

The Gold price jumped after the Mexican debt default in 1982, but so far has dropped even though Indonesia and now Russia have defaulted on their debt. What's the difference?

There are two differences. First, Mexico is a next door neighbor, with whom the big US banks have heavy exposure. Their exposure to Indonesia and Russia appears relatively small.

Second, nobody trusted the US Dollar in 1982 — memories of the 1970's inflation were still very vivid. Today nearly everyone has a tacit blind faith in the US Dollar. We are about to find out whether that blind faith is misplaced.

Many Americans say the US government will never let the currency collapse. Interestingly, the Russians used to say the same thing about their government, and they tragically are learning about the consequences of blind faith.

Why is Mr. Greenspan — purportedly an advocate of the Gold price rule — still concerned about inflation in view of the fall in the Gold price?

By the Gold price rule, a falling Gold price supposedly signals deflation, so the Fed should ease. Conversely, a rising Gold price signals inflation, so the Fed should tighten.

No one of course really knows what Mr. Greenspan is thinking, but I have a couple of ideas that may answer this question. First, Mr. Greenspan knows that inflation is the result of money growth, and he obviously knows that M3 and other measures of the quantity of Dollars are expanding at inflationary rates of growth.

Second, maybe Mr. Greenspan is thinking that Gold is giving a false signal. Mr. Greenspan would of course know if the Dutch are indeed dishoarding as I suspect — central bankers discuss those things among themselves, but we are left out of the secret. In any case, maybe Mr. Greenspan knows that the Gold price is falling not because of deflation but because the Dutch are dishoarding. So Gold is giving a false signal.

More disturbing to this line of thinking is a comment by Mr. Greenspan in testimony before Congress on July 27th. When discussing the issue of derivatives and cornering markets, he said: "Nor can private counterparties restrict supplies of gold...where central banks stand ready to lease gold in increasing quantities should the price rise". Was Mr. Greenspan answering in a theoretical way, or did he unintentionally let something slip. Unfortunately, we don't know, but it is potentially further evidence that the Gold price is being ignored by Mr. Greenspan because it is giving a false signal.

The CRB Index has fallen below 200, so are commodity prices heading lower still?

I don't think so. The lower end of the support range is actually 196, which is still holding. Also, you may recall that the components of the CRB were changed a couple of years ago, and natural gas was added to the Index. Not only did this change increase the energy component of the index, it added a lot of volatility. And right now, that volatility has been to the downside because natural gas, like other energy sources, is under extreme selling pressure.

In any case, support at the bottom of the multi-year trading range of the CRB is holding. Further, it looks like many commodities are in selling climaxes (as are the precious metals), so I think the CRB Index has probably reached bottom.

Won't the Fed be forced to lower interest rates? Won't lower interest rates help the stock market?

The yield curve is inverted, with all sectors below the Fed Funds rate. History shows that inverted yield curves are bad for the stock market, and the current swoon in the stock market further confirms this principle.

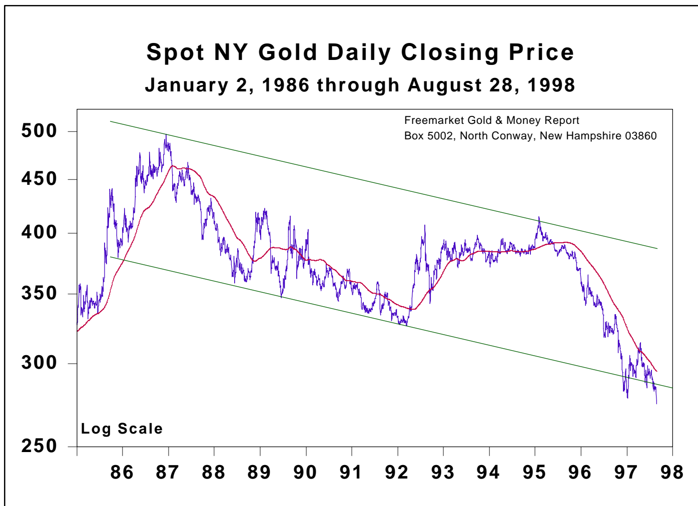
Some people believe the Fed will lower rates because of the collapse of so many overseas financial markets. It must be remembered, however, that the Fed only responds to overseas crises *if the domestic banking system is threatened*. So far, though bank stocks have collapsed and though I think we are headed for a banking crisis, there is not yet enough evidence to suggest that the banks are in trouble. For example, there is plenty of liquidity in the market, as evidenced by the fact that no banks have needed to borrow from the Fed. Therefore, the Fed Funds rate will remain unchanged for the time being.

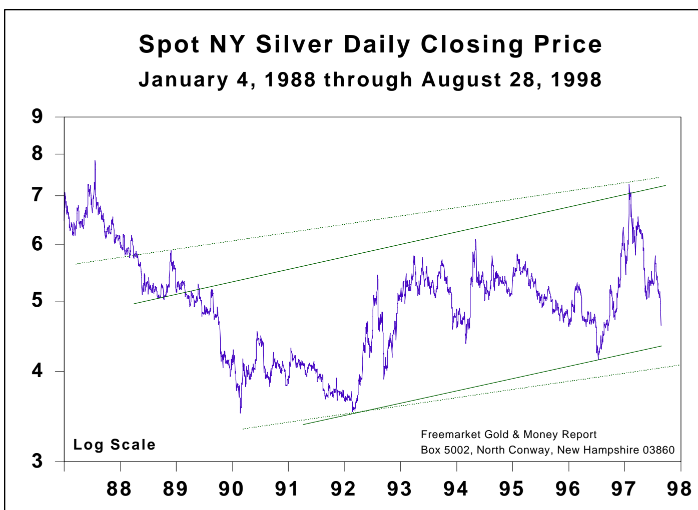
If the Fed Funds rate is eventually lowered, there is no reason to believe that the bull market will resume. Japan is a good case in point. Their stock market on Friday hit a new 12-year low, even though interest rates are 1.25% on Japanese government bonds. Lower rates do not always mean higher stock market prices.

While lower interest rates may mean improved earnings for many stocks, and less competition for investment Dollars from interest bearing instruments, the multiples that investors are willing to pay for earnings are more important to stock prices than the earnings themselves. And right now, the trend in that multiple is downward.

I recently heard a bullish stock market guru on CNBC say "who knows whether the bottom is tomorrow, a week or a month away" as he urged is listeners to plow hard earned money into stocks. His comment smacks of the unbelievably naive view investors have come to hold about the stock market. If he was really a 'guru', why didn't he say that the bottom could possibly be *eight years away*. After all, the Japanese bear market is already eight years and counting — without a bottom in sight. ¤

NEXT MAILING The next issue of *Gold & Money* is scheduled for mailing on September 14th. ¤





CURRENT MARKET SITUATION After holding above its January 12th low for more than seven months, Gold finally succumbed and broke to a new low. It is a disappointing turn of events, but it is way too early to write Gold's obituary. The price action over the next couple of weeks will be important to watch. The next few days in particular may yield some important clues about what happens to the Gold price from here.

In any case, traders should step off the sidelines and buy this dip. I expect this move's low will be made today, or possibly, it may have already been made on Friday. Whether it is THE low is another matter. I expect at least a meaningful bounce from these levels, and who knows what could be achieved from here. It could just be that Gold's bear market that began at the January 1996 peak may at long last be ending. Only time will tell for sure, but in the meantime, traders should buy this dip.

There are several reasons why this dip should be bought. First, bearish sentiment has moved into unbelievably low levels. The Bullish Consensus tally released by Market Vane this past Friday reports that only 15% of the analysts polled in its daily survey are bullish, one of the lowest readings on record. Combined with 16% bullish readings for both Thursday and Wednesday, it is clear that a contrary stance to prevailing opinion makes sense.

Second, even if Gold is eventually going to break lower, it is highly unlikely to do so now. Though Gold only broke down $10.60 over the past week, the market has become extremely oversold on this relatively small price move (it was only 3.7%). A bounce is in order before (if) Gold retreats to make a new low.

Third, if you go back and look at the low points that have occurred during Gold's downtrend over the past couple of years, the short-term low was often made on or near the last day of the month. I'm not sure why this phenomenon occurs, but it may be related to month-end over-the-counter option expiry. It may also be related to hedge funds pushing the market lower to achieve the most favorable result for their month-end marked-to-market valuation — they're nearly all short Gold and this additional selling adds to their month-end paper profit. (cont'd. on Page 4)

RECOMMENDATIONS (Basis spot prices and assumes trading is non-leveraged).

(1) Trading Portfolio: (For short-term traders).

GOLD - Traders are on the sidelines (the recommendation to buy the first close under $282 was negated because that close was also under the $278 stop-out point).

Traders should buy one trading position today (closing price for record keeping). Stop out this trade if Gold subsequently closes in New York more than $8 below your entry price.

Regardless what happens on the above trade, buy one trading position on Gold's first NY close above $282, and also buy one position on Gold's first NY close above $286. If either or both of these trades are filled, risk $8 basis New York closing prices from your highest entry point for all trading positions.

SILVER - On August 27th, traders bought one position at $4.855, that day's closing price. Buy one position today (the New York close for record keeping). Stop-out both of these positions if Silver closes in New York more than 25¢ below the entry price on today's purchase.

Regardless what happens on the above trades, buy one trading position on the first New York close above $5.22. If this trade is filled, risk 25¢ basis New York closing prices from your entry point for all trading positions.

GOLD/SILVER RATIO - On August 17th, traders covered at 55.83 the ratio sold on May 19th at 58.03. The profit on this trade was 3.8%.

Then on August 28th, traders again sold this ratio (i.e., bought Silver and sold Gold). The entry price was 59.3. Unwind this spread on the first New York close in the ratio above 60.5.

If stopped out, re-enter this trade on the first New York close in the ratio above 68, risking 2% from your entry price as a stop-out point, basis closing prices.

(2) Strategic Portfolio: (For long-term investors).

We are holding Gold bullion in an amount equal to 30% of our portfolio. Gold and the mining stocks remain good value, so investors should continue to accumulate bullion and/or Gold mining stocks and/or the Midas Fund, a no-load precious metals mutual fund for which I provide on-going advice and counsel.

(3) Options: (For experienced traders; basis COMEX).

Option volatility has increased, and we are at a good level to sell puts. I recommend selling the Dec 290 put (today's close for record keeping). Buy back this put if spot Gold closes more than $3 below today's closing price, or below $272, whichever level is lower.

It is tempting to buy a Gold call here (like the Dec 280 call). However, it is safer to first wait to see whether Gold holds current support, and then secondly, begins building some momentum. Therefore, buy the Dec 290 call if Gold closes in New York above $282. Hold without a stop-out point.

Remember, these option recommendations are high risk trades and are therefore not for everyone. ¤

Fourth, there are clear technical points at the moment for traders to get in and out. Gold is either forming a short-term "V" bottom (it rises from here as quickly as it dropped, forming a chart pattern that looks like a "V"), or it will work off the oversold condition by forming an "L" chart pattern (Gold moves sideways for 2-3 weeks, before breaking lower or rallying). Again, by my way of thinking, I expect the low to be made today, or possibly, it may have already been made on Friday, but the chart pattern is providing clear entry and exit points.

If traders reading this letter still doubt the wisdom about buying here, then take a look at the Page 3 chart. When Gold broke out of its downward sloping trend channel in early January, it reached an oversold position from which it launched a sharp rally. Once the oversold position was worked off, Gold eventually moved lower, finally breaking that January low this past week. And this current oversold position looks even more likely to produce a sharp rally. The reason is the expanding open interest on the Comex as the Gold price has fallen.

The short sellers are clearly 'piling on' (when combined with the over-the-counter shorts, which unfortunately cannot be accurately measured, it seems likely that the total short position in Gold is at a record level), and many of these new shorts are being held by weak hands. They will be quick to head for the sidelines on any Gold rally.

My point is that Gold may move lower still — neither I nor anyone else knows how the future will unfold — but I like playing the probabilities. Gold is even more oversold now than it was in January, so I expect another rally to begin from here. Read the Page 3 recommendations for entry levels and stop-out points.

Silver also looks like it is forming a "V" bottom. Traders stepped off the sidelines on Thursday to buy this dip. As I stated in the last Letter: "I still think a drop into the $4.80's is possible before the Silver market turns around to begin another short-term uptrend." We finally got that drop, and a bit more. Traders should add to their positions today. Again see the Page 3 recommendations for entry and exit points.

One final comment on Silver. The Gold/Silver ratio has moved back into our selling area (i.e., we buy Silver and sell Gold). The overhead resistance in the ratio at this level (around 59-60) adds further justification to buying Silver here. In other words, Silver is likely to find buying support as traders sell the ratio (i.e., they buy Silver and sell Gold).

However, if the ratio breaks above resistance in this area, it is logical to assume that it will then retrace all the way back to 68, which was the original break-out point. If we assume the low for Gold will be $272 (as noted, I think we are close to at least a short-term bottom) and we further assume the ratio touches 68, the implied Silver price is $4.

This price projection is supported by the Page 3 chart. Note that I have marked a second trend channel on the chart (dotted lines) to compare with the trend channel I have been presenting as Silver works its way higher. Interestingly, the bottom line of the new trend channel intersects around $4 per ounce Silver. Thus, even if the first up-channel does not hold, and even if Silver breaks below its $4.15 low of July 1997, Silver will remain in an upward trending channel, as long as it holds the $3.90-$4 area.

Given all the excitement about Silver over the past year as a result of Warren Buffett's monumental purchase, a new low below the July 1997 low may be in the cards to wring out of all of the excesses in the market, before Silver resumes its uptrend and pattern of accumulation.

I have no knowledge of what Mr. Buffett is doing, but I assume that if he liked Silver last year on supply/demand fundamentals, he must continue to like it. More Silver is still being consumed from aboveground stocks than is being mined, a continuation of an 8-year trend. Eventually, the physical demand for Silver will overtake available supply, causing the price to rise in order to 'clear the market', i.e., bring demand and supply back into balance.

To conclude, it will take a break of the long-term uptrend noted on the Page 3 chart to turn me bearish on Silver. As long as the long-term uptrend continues (and I include here the new lower sloping upward trend channel, which may yet be formed), Silver is being accumulated. ¤

INTEREST RATES We are on the sidelines waiting for an opportunity to sell short. The T-Bond remains in an uptrend, but the advance is looking ragged.

It is worth noting the latest Commitment of Traders report. Specs have increased their long position, while the commercial hedgers have increased their shorts. This disparity, which has become huge, is a signal that the uptrend is probably close to reversing. But for now, the uptrend remains in place, so we'll need to wait a bit longer before stepping in to sell short.

My recommendation is to sell short the Dec'98 T-Bond on the first close in this contract below 124-20. Stop out this short sale on the first close in this contract more than 1-00 point above your entry price. ¤

THE STOCK MARKET I suggested in the last letter that the bear market has probably begun. All of the additional evidence that has mounted up over the past couple of weeks adds further confirmation that the bear is taking hold. Investors should be watching the carnage from the safety of the sidelines.

Traders got whip-sawed. On August 18th at 8760, they got stopped-out of their short sale of the Sep'98 Dow Industrials contract from 8505 on August 4th. This contract has now fallen to the price at which I had hoped we would be covering shorts and taking our profits.

The point is that the stock market is probably ready for a bounce from here. Any bounce will create another opportunity to get short, which is the way traders should be playing this market, namely, from the short side.

The Dow should be able to manage to bounce back to at least the 8550 area, the current level of its 200-day moving average. So for now, traders should stand aside. I'll have some specific recommendations to sell short in the next letter. ¤

CURRENCY COMMENTS We hold Gold bullion as our Core Currency Position, which was established on November 2, 1994 at SFr 477.75 ($383.70) per ounce. As before, hold this bullion without any stop-out point.

We are long the Swiss Franc against the Dollar from SFr 1.497 on July 27th. Stop out this trade on the first weekly London close above SFr 1.526.

Traders sold short the British Pound on August 17th at $1.616, but were stopped out on August 28th at $1.6618. Even the Pound benefited from the recent bout of Dollar weakness, but the Pound still looks weak.

Sell short the British Pound the first day it closes in London above $1.670. Risk 2% on this trade, basis London closing prices. ¤

SOYBEANS Soybeans have continued to fall, and are now near $5 per bushel, which I expect will prove to be the rock-bottom price. When considering that one of the reasons for lower soybean prices was the weak Yen, soybeans should also start rising if the Japanese are ready to strengthen the Yen as Mr. Sakakibara suggests in the Page 1 article.

Therefore, I recommend buying the Nov'98 soybeans (today's closing price for record keeping). Risk 20¢ on this trade, basis closing prices. ¤